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Supreme Court of the United States,

OCTOBER TERM, 1922.

No. 260.

CHARLES KELLER, *et al.*, CONSTITUTING THE PUBLIC UTILITIES COMMISSION OF THE DISTRICT OF COLUMBIA,
Appellants,

vs.

POTOMAC ELECTRIC POWER COMPANY,
Appellee.

BRIEF FOR APPELLEE.

S. R. BOWEN,
Attorney and Counsel for Appellee.

JOHN A. GARVER,
JOHN S. BARBOUR,
Of Counsel.

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Supreme Court of the United States.

OCTOBER TERM, 1922.

No. 260.

CHARLES KELLER, *et al.*, constituting the Public Utilities Commission of the District of Columbia,
Appellants,

vs.

POTOMAC ELECTRIC POWER COMPANY,
Appellee.

Brief for Appellee.

Statement.

Appeal by the Public Utilities Commission of the District of Columbia from a decree of the Court of Appeals of the District, reversing a final decree of the Supreme Court of the District, which dismissed a bill of complaint in a suit in equity brought by the appellee, Potomac Electric Power Company, to review an order of the Commission fixing the value of the Company's property as the basis of rates to be charged by it.

The petition filed on behalf of the Commission in this Court to advance the hearing, states (p. 3) that upon the valuation made by the Commission, it reduced the rate charged by the Company to its

NOTE. Unless otherwise indicated, the references are to the top pages of the record.

domestic consumers for electric current 20%, and that the Company thereupon brought a suit in the Supreme Court of the District and obtained an injunction preventing the enforcement of this rate, pending the disposition of the present appeal, the difference meanwhile being impounded. At the time of filing the petition (in April, 1922), it was stated in the petition (p. 4) that the sum already impounded was about $2,500,000.

The Act creating the Public Utilities Commission of the District (copies of which are submitted with this brief) took effect on March 4, 1913 (37 Stats. 974). It conferred broad powers of regulation upon the Commission, including the power to establish rates (Pars. 41, 88, 94), and, as an incident thereto, the power to value the property devoted to the public use (Pars. 6, 7), and to modify the valuations from time to time, with changing conditions (Par. 9). The public utility companies are required to maintain their properties at full efficiency and to keep pace with all advancements in the art; and the Commission is required to see to it that this duty is performed (Pars. 2, 16, 96).

In April, 1914, the Commission organized a valuation bureau, with Edward W. Bemis, of Chicago (a professional witness for commissions and municipalities) as director. It employed Andrew Sangster, of Chicago, as its chief accountant, to ascertain the "historical cost" of the property of the appellee as of July 1, 1914, and Charles L. Pillsbury, of Minneapolis, with a staff of assistants, to determine the reproduction cost of the property.

The work of inventorying the property was commenced in June, 1914, and was continued through 1914 and the first half of 1915 (91, 931).

The reports of Mr. Pillsbury and Mr. Sangster were submitted to the Commission in 1916; and the

Commission thereupon gave notice to the Company that on June 26, 1916, it would proceed to a valuation of the Company's property used and useful in its business "at the time of said valuation" (49, 73, 77, 931), as a basis for fixing the rates to be charged by the Company (76-77). The hearings commenced on June 26, 1916 (77, 931); and the case was finally submitted to the Commission on January 31, 1917. The decision of the Commission was given on May 2, 1917 (925).

In the original notice, the Commission stated that the valuation would be made as of the time of the hearing (75). This was not done; but, on the contrary, the valuation was made as of July 1, 1914, nearly three years prior to the date of the decision, on the ground that, owing to the great war, later conditions were abnormal and did not furnish a proper basis for determining values (938-9, 976-7, 1020, 1030). Even the materials and supplies on hand at the time of the hearing were valued as of July 1, 1914 (979, 1024); and the Commission was not satisfied with taking values on July 1, 1914, but, in ascertaining reproduction cost, it took an average of three years prior to that date (975); and, in the case of copper, iron and other commodities, the costs taken represented an average of seven years prior to July, 1914 (976).

Additions to property after July 1, 1914, were taken at cost, without regard to the subsequent increases in prices (1000-1), which, as the appellants admit in their brief (p. 154), mounted up "by leaps and bounds".

The Company insisted throughout the hearings that reproduction value should be determined as of the date of the hearing, and that the Commission had no power to disregard the mandatory character of the statute on this point; and it

accordingly gave evidence of the reproduction value of the property as of July 1, 1916 (589, 706-7, 709, 712-14), and that no decline in prices had occurred to the date of finding (701-14, 915). This valuation was entirely disregarded by the Commission.

The enhancement in value of the structural property of the Company, which was actually in use on July 1, 1914, between that date and July 1, 1916, amounted to $2,521,246.88 (Appendix II, opposite p. 660).

The present suit was commenced by the Company in the Supreme Court of the District, in July, 1917, to review the order of the Commission, pursuant to the provisions of paragraph 64 of the Act, which expressly provides for a review of any valuation made by the Commission, where it is claimed that the order fixing the value is "unlawful, inadequate or unreasonable". That Court (Gould, *J.*) approved all the findings of the Commission and dismissed the bill. The Court was influenced by the view which it took of the Act, that it had no power to disregard any of the findings of the Commission, if there was any evidence to sustain them (50-1).

Upon appeal by the Company to the Court of Appeals of the District, the decree of the Supreme Court was reversed and the case remanded (1062), by a divided Court, Robb, *J.*, writing the prevailing opinion, which was concurred in by Van Orsdel, *J.* (1055), and Smyth, *C. J.*, filing a dissenting opinion (1058).

The reversal by the Court of Appeals was based on two grounds: (1) that the Court below was in error in its view of the limitation upon its powers; and (2) that the Commission and lower Court erred in finding the value of the property as of July 1,

1914, instead of its value at the time of the hearing. The Court, in its view of the case, did not consider it necessary to pass upon other questions raised.

On behalf of the Company, it is now urged that these controlling errors as well as other substantial errors were committed by the Commission and by the trial Court, which must lead this Court to affirm the decree of the Court of Appeals. These will be considered in the subsequent discussion of the case.

In addition to the two controlling grounds relied upon by the Court of Appeals, the more important grounds are:

> Disregard of well-settled principles of valuation;
>
> Improper deduction for depreciation, it being shown, without question, that no actual depreciation existed;
>
> Improper exclusion of various properties, upon untenable grounds.

The total value given to the properties of the Company by the Commission was $11,231,170.43 (71). If the valuation had been based upon correct principles, the total value should have been at least $20,000,000 (593).

The present appeal to this Court is expressly permitted by the statute (Par. 64).

POINTS.

FIRST.

Valuation made as a basis for rates.

The Commission (1067), as well as the Supreme Court of the District (52) and the Court of Appeals (1057), held that the purpose of the valuation was to establish a value upon which the Company should be allowed to earn an adequate return. In that conclusion, which is concurred in by counsel for the appellants (Brief, p. 2), they were undoubtedly correct.

I. Paragraph 6 of the Act expressly provides that the valuation shall be of property "used in or useful to the business of such public utility"; and paragraph 7 is even more explicit, in referring to the property to be valued as that "actually used or useful for the convenience of the public"; and the same phrase is employed in paragraph 20.

It is property used or useful in the service of the public upon which the utility is entitled to earn a return.

> Smyth *v.* Ames, 169 U. S., 466, 546-7;
> Stanislaus County *v.* San Joaquin Co., 192 U. S., 201, 213-14;
> Minnesota Rate Cases, 230 U. S., 352, 434-5;
> Denver *v.* Denver Union Water Co., 246 U. S., 178, 190-1.

II. If the valuation had been for any other purpose than rate making, *all* of the property of the Company would necessarily have been included.

SECOND.

Mistaken attitude of the Supreme Court of the District.

The Supreme Court of the District affirmed every finding of the Commission, on the mistaken theory that if there was any evidence to sustain a given finding, the Court had no power to disturb it (50-51). This theory was explicitly enunciated by the Court, in considering the question of working capital and supplies, as to which it said (59):

> "As the finding of the Commission was based upon substantial evidence, I have neither the right nor the disposition to substitute my judgment for that of the Commission."

Elsewhere, the Court said (p. 56):

> "As its conclusions were based upon substantial evidence, they will not, as already stated, be disturbed."

In this attitude, the Court erred in failing to distinguish between a finding based on a correct principle of law and one based upon an erroneous principle. It also failed to take into consideration, that it was its duty to protect the Company against the confiscation of its property and that the duty to review unlawful, inadequate and unreasonable findings had been expressly imposed upon the Court, to that end.

I. In the case of a review of findings by the Interstate Commerce Commission, where the appeal is heard on the record below, a finding of fact will not be disturbed, where there is substantial evidence to sustain it and where the finding is based upon a correct principle of law.

> Int. Com. Comm. *v.* Union Pac. Ry., 222 U. S., 541, 547.

This is also true where the review by the Appellate Court is expressly limited to questions of law and where the statute does not expressly give the power to review unlawful, inadequate and unreasonable findings of fact.

N. Y. & Queens Gas Co. *v.* McCall, 245 U. S., 345, 347-8.

II. It is beyond the province of legislation to confer upon a commission unlimited power to value property for rate making purposes, in denial of a judicial review of its exercise. A statute, which, in its effect, prevented such review, would be unconstitutional and void.

Ohio Valley Water Co. *v.* Ben Avon Borough, 253 U. S., 287;

Saratoga Springs *v.* Saratoga Gas, etc., Co., 191 N. Y., 123, 149.

III. Under the Public Utilities Act, the Court is given exceptionally broad powers of supervision and review, much broader than those conferred upon the courts by the Interstate Commerce Act.

1. The members of the Commission are not lawyers; and the statute expressly recognizes that, in valuation proceedings, the Commission may find it necessary to apply to the Court for advice. Paragraph 64 provides that whenever the Commission, in a valuation proceeding, is in doubt in regard to the elements of value, it may apply to the Supreme Court of the District for instructions.

2. The same paragraph (64) also provides for the review, as a matter of right, by the Supreme Court of the District of any order of the Commission fixing a valuation. This review is had by a suit in equity, in which the

> Court is required to set aside the order, if it finds that it is "unlawful, inadequate or unreasonable".

The proceeding differs very greatly from a strict appeal, as the plaintiff is not confined to the record before the Commission, but may introduce additional evidence upon the trial (Par. 67). The Court is thus distinctly required to review the facts as well as the law. It is, of course, its duty to set aside a valuation order, if the valuation is made in disregard of express statutory provisions, or if it ignores settled principles of law applicable to such cases. And, even on questions of fact, if the Court is of the opinion that a rate or valuation is inadequate, or that it is unreasonable, because insufficient or excessive, it is required to exercise its own judgment and is not limited to seeing whether there is any substantial evidence tending to sustain the finding of the Commission.

IV. The mistaken attitude of the trial Court is clearly shown in the following expression of it (p. 50):

> "At the outset of the consideration of the important questions involved, it is necessary to ascertain with exactness the jurisdiction possessed by this Court under the statute. It does not admit of question that any rule laid down by the Supreme Court in similar cases should be followed by this Court."

The Court then refers to the decisions of this Court arising under the Interstate Commerce Act.

The error of the trial Court could not be more clearly shown than by this failure to distinguish between the limited power of review under the Interstate Commerce Act and the compulsory rehearing which the Public Utility Act imposes upon the trial Court.

THIRD.

Factors in valuation.

The statute prescribes in a general way (paragraphs 6 and 7) the method to be employed by the Commission in determining the value of the property of a utility. The provision is largely an expansion of the frequently quoted statement of this Court in Smyth *v.* Ames (169 U. S., 466, 546-7).

The two controlling factors which the Commission is positively directed by the statute to comply with are the ascertainment of the investment actually made by the Company (historical cost) and the reproduction cost of the property *at the time of the valuation.*

I. Obviously, capital could not be obtained for public utilities, if those who contributed were not allowed an adequate return, commensurate with the risk involved, upon the amount contributed, always assuming, of course, that the expenditure of the capital has not been made wastefully and that the property has been maintained to give full efficiency of service and that no part of the property represented by the investment has been withdrawn from service without being replaced.

But the investor is entitled to something more than a return upon the exact amount contributed. Capital will not be attracted to these *quasi* public industries, unless it receives the same rewards as those which are obtainable in other industries. If there is an enhancement in the value of an investment, those who have contributed to it are entitled to a return upon the increased value, the extent of the return depending upon the price paid for the use of capital, from time to time, under

varying conditions. This fundamental principle has been expressly and distinctly recognized by this and other Courts.

Willcox *v.* Consolidated Gas Co., 212 U. S., 19, 48;

Lincoln Gas Company *v.* Lincoln, 250 U. S., 256, 267-8;

Saratoga Springs *v.* Saratoga, 191 N. Y., 123, 151.

II. If there has been no increase in the actual value of the investment, a return upon the amount invested must be given, with the qualifications above stated, even though the value found at the time of the appraisal may be less than the investment value; otherwise, the return would be insufficient to maintain the property in full efficiency, and it would be impossible to obtain additional capital for improvements and extensions, and, in the end, the consequences would be disastrous to the public, as well as to the utility.

Knoxville *v.* Knoxville Water Co., 212 U. S., 1, 14, 18.

FOURTH.

Present value must be taken.

I. In ascertaining the value of the property of a utility for rate making purposes, it is well settled that the value to be taken is the reasonable value as of the time when the inquiry is made regarding the rates.

San Diego Land Co. *v.* National City, 174 U. S., 739, 757;

San Diego Land Co. *v.* Jasper, 189 U. S., 439, 442;

Knoxville *v.* Knoxville Water Co., 212 U. S., 1, 9-10, 13;

Willcox *v.* Consolidated Gas Co., 212 U. S., 19, 41, 52;

Minnesota Rate Cases, 230 U. S., 352, 434-5;

Kansas City Southern Ry. *v.* United States, 231 U. S., 423, 449;

Galveston Electric Co. *v.* Galveston, U. S., ; 42 Sup. Ct., 351;

Houston *v.* Southwestern Bell Tel. Co., U. S., ; 42 Sup. Ct., 486.

II. That present value must be taken under the Public Utilities Act, is stated in language that leaves no room for doubt or discretion. Paragraph 7 of the Act is as follows:

> "Par. 7. That the commission shall value the property of every public utility within the District of Columbia actually used and useful for the convenience of the public at the fair value thereof *at the time of said valuation.*"

FIFTH.

Disregard of the statutory mandate.

Both the Commission and the Supreme Court of the District deliberately disregarded this unequivocal language of the statute; and, instead of finding the value as of the date when the valuation was made, they chose to determine that value as of July 1, 1914, two and one-half years earlier (938-9, 946, 975-7, 1017, 1020, 1030), although the record clearly showed that all costs of labor and materials had greatly advanced in the meantime (701-14, 915).

SIXTH.

Reasons for disregarding the statutory mandate unsound.

The reason given for the complete disregard of the express statutory provision was that, owing to the war and to the great increase of prices that ensued, any valuation as of the time when the valuation was made would be abnormal and unreasonable, unfair to the public and in violation of sound economic principles (938-9, 976-7, 1020, 1030, 1049).

I. Even if it were conceded, for the sake of the argument, that the economic reason advanced by the Commission and the Supreme Court (57-59) for disregarding the statutory direction was entirely sound, and that Congress did not take into consideration all the consequences of the language employed in the Act, yet that did not give the Commission power to refuse to perform the duty which had been laid upon it. Congress may have been in error in requiring the value to be ascertained as of the date when made. But Congress is the supreme regulatory body for the District; and until the Commission convinces Congress that the statute is not based on sound economic grounds, it must bow to the superior power that created it.

Kansas City Southern R. Co. *v.* I. C. C., 252 U. S., 178.

In that case, the Interstate Commerce Commission, in valuing the property of the Railway Company, failed to comply with the direction of the statute to ascertain and report, *inter alia*, the present cost of condemnation and damages or of purchased property in excess of the original cost or

present value, apart from improvements. The Commission failed to comply with this requirement, because, in its opinion, the statute required something to be done which was "beyond the possibility of rational determination" and called for "inadmissible assumptions" and the "indulging in impossible hypotheses" as to subjects "incapable of rational ascertainment". Held, that this was no reason for disregarding the explicit direction of the statute and that the Commission could not exercise the power conferred upon it by the Act, and, at the same time, disregard the essential conditions imposed by Congress upon its exercise.

II. In the Kansas City Southern case, the Court merely applied the general principle, that, in every case where a public body with limited powers is charged with the performance of a duty, it must observe the conditions prescribed for the exercise of that duty.

Bank of California *v.* Richardson, 248 U. S., 476, 485;

First Nat. Bank of Gulfport *v.* Adams, U. S., ; 42 Sup. Ct., 323.

III. If suitable conditions were not imposed by the legislative body upon the acts of the Commission, for the protection of the utility, the delegation of the legislative authority would be void.

Wichita R. R. & L. Co. *v.* Pub. Utilities Com., U. S., (decided Nov. 13, 1922), 43 Sup. Ct., 51;

Saratoga Springs *v.* Saratoga Gas, etc., Co., 191 N. Y., 123, 149.

IV. In the present case, there was even less excuse for disregarding the statute than there was in

the Kansas City Southern case; because, while laying down, in unmistakable terms, the principle to be followed in this District, Congress immediately provided for the correction, at any time, by the Commission of the valuation made, if changing conditions called for such correction. Paragraph 9 of the Act is as follows:

> "That the commission may, at any time, on its own initiative, make a revaluation of the property of any public utility."

If, therefore, the conditions existing in 1916 were abnormal, yet, when they again became normal, the power to modify the previous valuation was expressly conferred.

V. What is abnormal is a highly complex question. An unusual condition suddenly arising may at first seem abnormal; but, if that condition is continued for several years, with no definite prospect of its termination, it may become entirely normal.

What the Statutory Court (three judges) said in the case of Joplin & Pittsburgh Ry. Co. *v.* P. S. C. of Mo. (267 Fed., 584) is highly pertinent:

> "It appears upon the face of the report (of the commission) that great, if not undue, emphasis was laid upon the original cost of the property . . . at a period greatly antedating that with which this investigation must deal; nor can we say that the present period of high prices is so temporary or abnormal that it may practically be disregarded in arriving at the value of complainant's properties. No one can say what degree of depression may ultimately come, but it is reasonably certain that the cost of the properties now under consideration will never again approximate figures prevailing in the years before the World War."

VI. In the most recent Consolidated Gas case, decided March 6, 1922 (256 U. S., ; 42 Sup. Ct., 264), the suit was commenced in January, 1919, and the property was valued and the rate fixed on the basis of prices prevailing in 1918. On that basis, the District Court declared confiscatory and void a statute limiting the rate to be charged to eighty cents a thousand cubic feet. The decree of the District Court was unanimously affirmed by this Court, as were also a number of decrees obtained by other New York gas companies, upon similar evidence (42 Sup. Ct., 438).

VII. Time has shown how completely the Commission and the Supreme Court of the District were in error in the present case, when they assumed that the conditions of 1915 and 1916 were abnormal and temporary. Prices continued to mount steadily and rapidly after the entrance of this country into the war, in April, 1917, and did not reach their maximum until 1921. Even now, the prices of coal, oil, labor and materials are far in excess of those which prevailed in 1915 and 1916.

VIII. The effect of the war upon values must be considered by the Commission in determining the present value of property, and that pre-war values alone cannot be taken has recently been unanimously decided (July 6, 1922) by the Appellate Division of the Supreme Court of the State of New York (five Justices).

People *ex rel.* N. Y. State Railways *v.* Pub. Serv. Comm., 202 App. Div., 576.

In that case, the Commission had adopted a pre-war cost of the property and had disregarded evidence given by the Railway Company of much

greater values during and after the war. In reaching the conclusion that it was an error to disregard these increased costs, the Court said (p. 577):

> "The relator submitted evidence of much greter value during the war and after the war, all of which manifestly was ignored. The Commission has clearly fallen into the error pointed out by this Court in People *ex rel.* Iroquois Natural Gas Co. *v.* Pub. Serv. Comm. (194 App. Div. 578). All of the evidence should be considered in its entirety. Different elements require consideration in estimating value. As stated by Mr. Justice Hughes in the Minnesota Rate Cases (230 U. S. 352, 434): 'The ascertainment of that value is not controlled by artificial rules. It is not a matter of formulas, but there must be a reasonable judgment having its basis in a proper consideration of all relevant facts.' The evidence introduced by the relator was relevant. It has not been considered. We do not mean to say that the value of the property should be estimated at what its reproduction at the present time would cost. Equally true is it that its cost before the war is not the exclusive criterion. The Commission cannot arbitrarily take that cost as the present value. It would seem that the present value must be something more than pre-war cost less depreciation. There should be 'a proper consideration of all relevant facts'. Our criticism is that all relevant facts have not been considered. The opinion of the Commission (Matter of New York State Railways, 26 State Dept. Rep. 381, 384) shows that it is based entirely on the testimony of the experts of the City, to the effect that the actual cost of the property is 'the *normal* reproduction cost (pre-war)', and such pre-war cost is taken as the present actual value in fixing the rate base. It is clear, therefore, that no consideration has been given to rising prices, changing economic features, and other

> elements bearing on the question as to what is a proper return under present day conditions. The incomplete method of valuation has necessarily reduced the total valuation of the relator's property so substantially as to make it uncertain whether an adequate return on such property has been allowed."

That decision was made merely in reliance upon the general principle, that present value is controlling in determining the valuation of a public utility. The Court thus reached a conclusion which the Public Utility Law of the District explicitly requires the Commission to observe.

IX. Congress was right in requiring present value to be taken in estimating the cost of reproduction. A public utility corporation is entitled, at all times, to a reasonable return upon the value of its property devoted to the public use; and that right cannot be impaired by a valuation in a rate case, which does not allow a reasonable return, any more than it can be impaired in cases where the entire property is taken for the public use, in the exercise of the right of eminent domain. Even if, from an economic point of view, the contentions of the Commission and the trial Court were conceded to be sound, they could not be applied by reason of constitutional restrictions.

SEVENTH.

Mistaken theory of valuation.

The Commission completely disregarded the well settled method of valuing the properties of the Company. By a somewhat elaborate process of reasoning, it persuaded itself that the method to be employed in valuing property in a rate case was different from that which is applied in all other cases. It was of the opinion that, in appraising property for rate making purposes, you must constantly bear in mind the public and ascertain what the property is worth to the public, as well as to the Company itself (1045, 1048). In this way, you obtain the fair "amount" to be allowed for the property. In its own language (1045):

> "The object and purpose of every valuation upon which rates are to be based is an ascertainment of but one thing, not what the property is worth as an income producing instrumentality, *not for what it could sell or be bought* . . ., but a determined amount, an ascertained and fixed sum, upon which the owner may earn a fair and reasonable return . . .
>
> If the word 'amount' is substituted in place of the word 'value', in paragraph 7 of the Public Utilities Law, and, in the judgment of the Commission, such a substitution not only does no violence to the word 'value', but gives to it a meaning which Congress intended it should convey, it would follow that it is the duty of this Commission to ascertain the fair amount which should represent a just basis for rates of this particular utility as of the time so determined."

And, again (1047):

> "To say that rates are to be based upon the value of the property, using the term in its usual and ordinary sense, is to say that rates shall be based upon one premise today, another tomorrow. So we must conclude that when the courts said that rates were to be based upon 'fair value', they could not have meant to use the word 'value' in the sense in which the word is ordinarily used and understood."

I. The method thus adopted has no support either in the language of the statute or in the decisions of the courts; and it obviously could have none. Neither the legislature nor the courts can deprive a person of his property, without giving him just compensation for it; that is, paying him what it is actually worth at the time it is taken. A utility is entitled to an adequate return upon the reasonable value or worth of its property devoted to the public use. The value must be determined in a rate case in the same manner as in a condemnation proceeding, under the exercise of the power of eminent domain.

> Reagan *v.* Farmers L. & Tr. Co., 154 U. S., 362, 407-8, 410;
>
> San Diego Land Co. *v.* National City, 174 U. S., 739, 757;
>
> Minnesota Rate Cases, 230 U. S., 352, 434, 454.

And when that has been done, and not until then, does the question of what is "fair" to the public arise, in fixing the rate to be charged. That depends upon general economic conditions, which necessarily change from time to time. At some

times, a return of 6% may be fair to the public, as well as to the company.

Willcox *v.* Consolidated Gas Co., 212 U. S., 19, 50;

while, under other conditions, it may be 8% or more,

Lincoln Gas Co. *v.* Lincoln, 250 U. S., 256, 267.

The Supreme Court of the District adopted the valuation made by the Commission, but based its decision upon a different ground. It disregarded the language of the statute altogether in requiring reproduction value, as well as investment value, to be ascertained, and confined its attention exclusively to investment value, upon which it was of the opinion that the valuation made by the Commission was justified (53).

II. The Commission erroneously assumed that the actual amount of the investment represented by property in existence at the time of the inquiry marked the limit of the fair value of the property for rate making purposes (1048-1052); and in valuing the property, it pursued the easy method, so frequently resorted to by juries, of accepting the general average. The average taken in the present case was approximately that of the assumed historical cost (which disregarded the reports and books of the Company) and reproduction value as of July 1, 1914, with the capital additions subsequently made, at cost (1050-52).

EIGHTH.

Theoretical depreciation.

In valuing the property of the Company, the Commission deducted a very large amount for assumed theoretical depreciation, although it was proved and conceded that no depreciation in fact existed; and this deduction was approved by the Supreme Court of the District (61).

This arbitrary deduction was made on the so-called "straight line" theory of depreciation, a theory which assumes that the composite plant of a public utility is like a single tool or machine and has a definite, ascertainable life of a given number of years, and deteriorates ratably each year until its life becomes extinct, at the end of the imaginary period.

A utility is thus, in effect, treated like a mine, whose contents are definitely known, the exhaustion of which can be determined with mathematical precision and where nothing extracted is ever restored.

As the valuation reached by making this deduction for an assumed depreciation that did not actually exist was for the purpose of establishing a rate base, its necessary effect was to deprive the Company of any return upon the amount deducted; and, as the theory upon which it was made was erroneous, a large amount of the Company's property was confiscated, in disregard of constitutional safeguards.

I. The Commission found (1042, 1051) that the cost of reproduction of the Company's physical property within the District, as of July 1, 1914, was..... $11,090,228.78
and it estimated the "accrued depreciation" at 1,977,385.87

leaving a net value of..... $9,112,842.91
It found the historical cost of the same property to be..... $9,212,513.09
and the "accrued depreciation"... 1,642,591.09

leaving a net value of..... $7,569,922.

The Commission did not recede from these figures, although it ultimately valued the property within the District as of July 1, 1914, at $10,250,000 (1052), which is a deduction from reproduction cost of $840,228.78, instead of the "accrued depreciation" actually found. The difference is partly accounted for by allowing something for "intangibles and cost of development" (1051), the amount of which is not stated.

This very large deduction was made in face of the testimony of the Commission's own engineer (Mr. Pillsbury), that the plant was 100% efficient. He testified that the plant of the Company was in as good condition as on the day when it was completed, and that it would render just as good service for another sixty-six years (his estimated life of the plant), "provided the maintenance is continued on its present basis" (333-4). He further testified that depreciation was not figured from the standpoint of physical deterioration, and that so far as the property of the Company was concerned, there was practically no depreciation (344). He did not stop with the general statement, but said

that the property of the Company was "maintained in fully as good condition as it should have been maintained and in a broad sense; and that any other and further expenditures on it for maintenance than those that have been made on it would have been unwise"; and he added: "I would say that it was as near 100% efficient as could normally and reasonably be expected of an operating utility". He admitted that, on his theory, this so-called "accrued depreciation" did not indicate nor imply physical deterioration, loss of efficiency or loss of public service ability. It was figured solely on life expectancy (102-5); and life expectancy "is an estimate and always must be an estimate . . . is never anything more" (332).

In its opinion, the Commission referred to these undisputed facts, and said (1038):

> "Such first-class physical or service condition of the property is not denied; in fact, it was testified to by witness Pillsbury. As clearly stated in the second paragraph under the heading 'depreciation' . . . accrued depreciation, as set forth in that report, does not indicate nor imply corresponding (nor any particular) physical deterioration, loss of efficiency or loss of personal service ability, but does indicate corresponding loss with respect to possible service ability or potential service capability through loss of proportional part of service life."

The Commission further said that the property was "to all intents and purposes devoid of deferred maintenance and in first-class service condition" (1038).

The Commission attempted to bolster up its acceptance of the straight line theory of depreciation employed by its engineer, by stating (1038) that the Company's witness, Mr. Almert, had admitted

that he had "examined Mr. Pillsbury's rates of depreciation and found them to be approximately fair"; and the Supreme Court of the District also, in its opinion, assumed that such an admission had been made (61).

Mr. Almert had no intention of indorsing Mr. Pillsbury's visionary theories. On the contrary, he testified positively that the property was in 100% operating condition, and that there should, consequently, be no allowance for depreciation (699-700). He merely stated that on the life expectancy guess and assumption of Mr. Pillsbury, he had made a correct computation.

II. Only during the past few years has the question of depreciation in connection with public utilities received careful consideration. At the outset, depreciation was assumed to exist as a matter of course. Those who had no occasion to consider it seriously were very naturally misled by the false analogy of a single article or machine, whose life is definitely limited and can be determined with approximate accuracy. The principle is not applicable, however, to the extensive and complex system of a public utility composed of innumerable parts, where the property, as a whole, is required by statute to be maintained at 100% efficiency out of earnings, by a charge sufficient to take care of all repairs, renewals and replacements.

In the early days of regulation, it was also assumed by the public officials that it was to the interest of the public to establish a large depreciation, so as to reduce the rate base upon which the utility should receive a return, not stopping to reflect upon the crippling effects which this theory would have upon the efficient maintenance of the utility itself and of the disastrous consequences, in

the long run, to the public, which was dependent upon it.

> Knoxville Water Co. *v.* Knoxville, 212 U. S., 1, 18.

This unsound theory has been supported by doctrinaires, by advocates of municipal ownership, by the engineering staffs of commissions and municipalities and by a band of so-called experts, who find profitable employment at the hands of municipalities and commissions intent upon reducing values to a minimum, in the interest of the popular vote and with the expectation, in many cases, of thus making it easier to bring about municipal ownership and operation of public utilities.

In support of their contention, these experts and commissioners have largely relied upon the statement contained in the opinion of this Court, written by Mr. Justice Moody, in the Knoxville Water case (212 U. S., 1, 13), that "a water plant, with all its additions, begins to depreciate in value from the moment of its use".

When that statement is read in connection with what immediately precedes and follows it, it is evident that the Court intended to assert and did assert unequivocally that any possible depreciation should be avoided by a charge which would enable the Company at all times to maintain its plant to full reproduction value. The complete statement of the Court on the subject is as follows (p. 13):

> "A water plant, with all its additions, begins to depreciate in value from the moment of its use. Before coming to the question of profit at all, the company is entitled to earn a sufficient sum annually to provide not only for current repairs but for making good the depreciation and replacing the parts of the property when they come to the end of their life. The company is not bound to see its property

> gradually waste, without making provision out of earnings for its replacement. It is entitled to see that from earnings the value of the property invested is kept unimpaired, so that at the end of any given term of years the original investment remains as it was at the beginning. It is not only the right of the company to make such a provision, but it is its duty to its bond and stockholders, and, in the case of a public service corporation at least, its plain duty to the public. If a different course were pursued, the only method of providing for replacement of property which has ceased to be useful would be the investment of new capital and the issue of new bonds or stocks. This course would lead to a constantly increasing variance between present value and bond and stock capitalization—a tendency which would inevitably lead to disaster either to the stockholders or to the public, or both."

This statement was called forth by the unsound contention, on the part of the Company, that in valuing its property, there should be included property which, "through destruction or obsolescence, had actually perished as useful property" (p. 13). The Court properly held that the property which had disappeared or had been superseded should have been paid for out of current earnings; in which case, there would obviously have been no ground for deducting anything for depreciation. That renewals and replacements, as well as repairs, should be provided for out of earnings, is thoroughly well established.

> Kansas City Southern Ry. *v.* United States, 231 U. S., 423, 451-2;
>
> Galveston Electric Company *v.* Galveston, U. S., ; 42 Sup. Ct., 351;
>
> People *ex rel.* Binghamton, etc., Light Company *v.* Stevens, 203 N. Y., 7, 22, 25.

III. That this Court did not intend to lay down any "straight line" theory of depreciation in the Knoxville case is evident from its decision in the Consolidated Gas case, announced at the same time as that in the Knoxville case (212 U. S., 19). In the Consolidated case, the Master had refused to find any depreciation in the value of the Company's plant; and his decision had been affirmed by Judge Hough (157 Fed., 849), who said (pp. 854-5):

> "In every instance, the value assigned in the report is what it would cost presently to reproduce each item of property in its present condition and capable of giving service neither better nor worse than it now does."

The method thus employed, which did not make any allowance for accrued depreciation, was accepted by this Court (212 U. S., 19, 52).

No better example could be given than that of the Consolidated Gas Company, whose property dated back to the year 1823, when the first of its constituent companies (the New York Gas Light Company), and possibly the first in this country to supply gas to the public, was organized.

IV. This Court distinctly recognized that facts must prevail over the formulas of theorists, in discussing the bases of valuation in the Minnesota Rate Cases (230 U. S., 351, 456-7): "the ascertainment of that value is not controlled by artificial rules. It is not a matter of formulas."

The same thought was thus expressed by District Judge Booth, in London *v.* Court of Industrial Relations (269 Fed., 433, 445):

> "In my judgment, the element of depreciation should not be measured by a theoretical yard stick but should be determined by careful consideration of the actual facts."

V. In the recent case of the Consolidated Gas Company, decided by this Court on March 6, 1922 (Newton *v.* Consolidated Gas Co., 256 U. S., , 42 Sup. Ct., 264), the defendants contended that a large amount ($6,507,400) should be deducted from the value of the Company's plant for depreciation, based entirely upon the "straight line" theory. There was uncontradicted evidence that the property of the Company had been adequately maintained; and the Master refused to deduct anything for depreciation. His decision was approved by Judge Learned Hand (267 Fed., 231), who made the following comment on the subject (p. 265):

> "Maltbie figured a 'straight-line' depreciation of $3,500,000 for all plants and holders. This was necessarily a conjecture, based upon the supposed life of the plant; it has no application while the plant is kept up . . .
>
> The other elements of depreciation are for mains, about $1,500,000, and services and meters, $1,500,000. Any depreciation in the mains appears to me quite fanciful. Little said that the life of a main when properly buried, was indefinite; the only question is of obsolescence and repairs, and I should suppose that obsolescence would occur only after it got too small for its requirements. It might, of course, be possible to show that all necessary mains could now be laid for less than the book cost; but the plaintiff has shown the contrary by Miller, and it is not contradicted . . .
>
> The allowance for repairs might be attacked on the ground that the condition of the plants and fixtures in fact required inordinate repairs, but that was not done. In accordance with the principle which I have tried to demonstrate, I decline to make any allowance for depreciation."

NOTE: This entire subject of theoretical depreciation was very fully discussed and the decisions on the subject were exhaustively reviewed by counsel for the Consolidated Gas Company in that case, in the brief submitted to this Court in No. 257, "On the facts and incidental questions of law" (pp. 368-460).

VI. When the courts and commissions opened their eyes to the obvious facts in the case of the great public utilities, it was inevitable that the visionary theories of doctrinaires without practical experience, or professional witnesses who never have assisted in the construction or operation of a single plant, but who were hired to support an unsound theory, should give way to actual conditions.

With the advance in the arts, and with the results of experience, the great railroad systems, traction lines, lighting, heating and power and water systems are undergoing constant improvements. The renewals and replacements in most instances represent something better and more efficient than that which has been superseded; and these utilities render more efficient service, where they have not been prevented from doing so by a too rigorous regulation of their business. In the case of a railroad, better roadbed, more powerful locomotives, larger and safer cars and heavier rails and improved appliances take the place of those which are withdrawn from service; and a company such as the respondent, furnishing electrical current, shows a constant increase in efficiency and value, owing to the rapid development of the art and the constant improvements in details of operation. Thus, instead of depreciation, appreciation is constantly taking place in public utilities that are maintained at 100% efficiency. The verification of this statement is seen in the valuation of the property of this appellee, and, indeed, of all well managed utilities, which show that reproduction cost is almost invariably in exeess of original record cost. A striking example of this truth was given in the New York gas cases recently before this Court, where that fact was

shown in the valuation of the property of every company. The tendency of the property of an efficiently managed public utility to appreciate was recognized by this Court in the recent Galveston case (*supra*).

VII. Wherever regulatory acts have been passed, there will be found the positive requirement that the utilities shall maintain their properties at full efficiency; and such provision is contained in the Public Utilities Act of the District (Pars. 2, 16, 96).

VIII. That there should not be any theoretical depreciation in the value of the plant of an efficiently operated utility, where actual depreciation is not shown, is now generally recognized by the courts and commissions.

Nashville, C. & St. L. Ry. *v.* United States, 269 Fed., 351;

Havre de Grace, etc., Bridge Co. *v.* Towers, 103 Atl., 319 (Md. Ct. of App.);

Murray *v.* Public Utilities Commission, P. U. R. 1915 F, 436 (Idaho Sup. Ct.);

Ben Avon Borough *v.* Ohio Valley Water Co., 75 Pa. Sup. Ct., 260.

One of the most recent decisions is that of the Circuit Court of Appeals of the Sixth Circuit, in the Nashville, C. & St. L. case (*supra*), where accrued depreciation on the straight line theory was assailed by counsel for the Government and unanimously rejected by the Court.

In the Havre de Grace Bridge case, the Court said, in referring to an item of "main depreciation reserve":

> "This was based not upon any direct ascertainment of actual deterioration in the bridge

structure, but upon the basis of the estimated future life of the bridge. It is difficult to characterize this by any other term than guesswork. . . . By a similar process of reasoning, it would have been entirely possible to have reached any valuation which might have been desired."

Holding that the method adopted and the result obtained was unreasonable, the Court reversed the action of the Commission.

In Bonbright *v.* Geary (210 Fed., 44), the Statutory Court held, unanimously, that a reserve which had been created to take care of the depreciation of the property should be included in the valuation of the plant, and not deducted.

The public service commissions have also commenced to see the light, as is evidenced by the following decisions:

Arkansas.

Milwaukee Electric, etc., Co. *v.* Milwaukee, P. U. R. 1918-E, 1, 27;

Re Mineral Point Service Co., P. U. R. 1919-A, 795;

Arkansas Light & Power Co., P. U. R. 1920-D, 775;

Idaho.

Wood River Power Co., P. U. R. 1921-B, 531;

New Jersey.

Re Medford Gas Company, P. U. R. 1919-E, 707;

New York.

Re Binghamton Light, etc., Company, 24 State Dep. Rep., 651, 655;

Hoffman *v.* Elmira Water, etc., Company, P. U. R. 1920-D, 266;
Re New York State Railways, P. U. R. 1921-C, 496;
Amherst *v.* Snyder Gas Company, P. U. R. 1921-D, 540.

It is believed that there are no decisions of the courts recognizing the straight line theory of depreciation.

The opinions of Hon. Charles E. Hughes, in the Minnesota Rate cases, and later in the Brooklyn Borough Gas case (17 State Dep. Rep., 81), in which he acted as Referee, are sometimes cited by the theoretical depreciationists in support of their contention.

In both of those cases, the decision was based, not on fanciful theories but on uncontroverted facts; and, in the Brooklyn Borough case, theoretical depreciation was expressly rejected. In the Minnesota Rate case, the Court properly disallowed certain old structures and equipment that were no longer in use; but it expressly held that "there should be specific findings showing the items which enter into the account of physical valuation on both sides", that is, appreciation as well as depreciation (230 U. S., 457-8); while, in the Brooklyn Borough case, it refused to accept "accrued theoretical depreciation", which had been elaborately worked out in tables prepared by the defendant's professional experts; and it allowed only the actual depreciation which the Company itself showed and conceded.

IX. The Public Utilities Act of the District expressly provides for the application of the prin-

ciple which has thus been so generally recognized. Paragraph 16 is as follows:

> "That every public utility shall carry a proper and adequate depreciation account. The commission shall ascertain and determine what are the proper and adequate rates of depreciation of the several classes of property of each public utility. These rates shall be such as will provide the amounts required over and above the expense of maintenance to keep such property in a state of efficiency corresponding to the progress of the industry. Each public utility shall conform its depreciation accounts to such rates so ascertained and determined by the commission. The commission may make changes in such rates of depreciation from time to time as it may find to be necessary. The commission shall also prescribe rules, regulations, and forms of accounts regarding such depreciation which the public utility is required to carry into effect. The commission shall provide for such depreciation in fixing the rates, tolls, and charges to be paid by the public. All moneys in this fund may be expended in keeping the property of such public utility in repair and good and serviceable condition for the use to which it is devoted, or invested, and, if invested, the income from the investments shall also be carried in the depreciation fund. This fund and the proceeds thereof shall be used for no other purpose than as provided in this paragraph, unless with the consent and by order of the commission."

This language does not contemplate a reserve fund constantly increasing in size and uselessness from year to year, in expectation of the ultimate termination of the life of the plant, but only an amount sufficient from year to year to take care of all repairs, renewals and replacements. These will vary with the conditions surrounding each plant.

The expenditures in one year may be more or less than the expenditures of another year; but experience will enable the amount to be collected from the public on an average basis. In the New York gas cases recently before this Court, it was found that a charge of three cents a thousand cubic feet was sufficient to comply with this requirement, without unnecessary accumulation.

If, owing to obsolescence or inadequacy, it should become necessary, in any year, to make an unexpectedly larger expenditure for replacements than would be covered by the annual allowance, the charge should be increased to enable the additional expenditure to be amortized over a reasonable period. In this way, the public which would receive the benefit resulting from the more economical replacement in the plant would pay for it, and not those who had not received that benefit.

X. The inevitable conclusion from the language of the Act, as well as from sound economic principle, is that reproduction value must be taken, without allowance for depreciation, unless it is found as a fact, upon proper evidence, that the present value of the plant is less than the reproduction value, due to deferred maintenance. In that event, the facts should be expressly found from which the conclusion follows. In the Minnesota Rate case, the Court said (p. 457):

> "It is also to be noticed that the depreciation in question is not that which has been overcome by repairs or replacements, but is the actual existing depreciation in the plant as compared with the new one. . . .
>
> When *particular physical items* are estimated to be worth so much new, if *in fact* they be depreciated, *this amount* should be found and allowed for."

NINTH.

Property erroneously excluded.

Three important properties (the Graceland Cemetary tract, the Great Falls Power site and the I Street sub-station), carried on the books of the Company at an aggregate value of over a million dollars, were excluded by the Commission and the Supreme Court in making their valuation, although the Director of the Valuation Bureau of the Commission admitted that property which had been bought in anticipation of need should be valued at cost and included (527). The exclusion of the first two items was based on the assumption that they were not presently used or useful in the Company's business (998, 1027-9, 55-6), while the sub-station was excluded on the theory that it did not cost the Company anything.

I. The Graceland Cemetery tract, which cost $116,155.80 (748), was appraised by the Commission's engineers at $160,490, and by the Company's engineers at $227,466 (441).

Mr. Ham, the President of the Company, testified that the property had been acquired for future use, in view of the probable necessity of ultimately being obliged to vacate the premises at 14th and C Streets, which are on the direct line of the future development of the City (446, 749, 815). While perhaps the entire value of this property should not be allowed to the Potomac Company, in view of its possible joint use with the Washington Railway and Electric Company, yet, as Mr. Ham's testimony stands undisputed, the Commission was not at liberty to exclude the entire value.

II. The Great Falls Power site comprises about one thousand acres at Great Falls, on both sides of the Potomac River, consisting of about eight hundred acres on the Virginia side and two hundred acres on the Maryland side, with some islands in the River. The title is held by the Great Falls Power Company, two-thirds of whose stock was purchased in 1902 for 425,000 by the Washington Railway & Electric Company on behalf of the Potomac Company, which was not then in position to make the purchase itself. For this site, the Potomac Company, in 1912, issued its full paid common stock for $1,000,000, par value; and the Company's witnesses testified that at the date of the hearing, the investment was fairly worth $1,000,000 (639, 861).

Mr. Ham, the President of the Potomac Company, testified that plans had been made for the development of this water power whenever it became evident that power could be developed there by water more economically than by steam (748-9).

Additional reasons advanced for the exclusion of this property were that the Potomac Company had paid too much for the interest in the property, that there was possibly some difficulty in connection with the title, and that the United States Government had rights in connection with the use of the water which might interfere with its efficient use by the Company. No actual defect in the title having been shown, it will not be assumed, in a valuation proceeding, that any exists, merely because there may be some questions in connection with the title which are not entirely free from doubt; and as to the United States Government, even if it had been shown that it possessed water rights which might affect the value of those owned by the Potomac Company, that would merely introduce a factor in valuing the property and would not justify its exclusion altogether.

III. The significant fact about these two properties is that there was no contradiction of Mr. Ham's testimony, that the properties were acquired to meet the future needs of the Company.

IV. The powers of the Commission under the Utilities Act are administrative and regulatory. The Act does not confer any authority upon the Commission to control the discretionary power of the Board of Directors in the general management and policy of the business of the utility. While the Commission may decide what must be done to afford adequate service, the directors and officers have the sole power to decide how it shall be done and how the Company can best meet the demands that the public may make upon it. This limitation upon the powers of the Commission has been clearly pointed out by the New York Court of Appeals, in a number of decisions based upon the Public Service Commission Law of that State, which, in many respects, confers broader powers upon the Commission than are conferred by the District Utilities Act.

People *ex rel.* D. & H. R. Co. *v.* Stevens, 197 N. Y., 1;

People *ex rel.* New Haven R. R. Co. *v.* Willcox, 200 N. Y., 423, 431;

People *ex rel.* Binghamton, etc., Power Co. *v.* Stevens, 203 N. Y., 7, 20;

People *ex rel.* N. Y. Central, etc., R. Co. *v.* Commission, 215 N. Y., 214.

In the Delaware & Hudson case (*supra*), the Court, in a unanimous opinion written by Haight, *J.*, said (p. 10):

"We do not think the legislation alluded to (the P. S. C. Act) was designed to make the

> Commission the financial managers of a corporation, or that it empowered them to substitute their judgment for that of the board of directors or stockholders of a corporation as to the wisdom of the transaction."

Again (p. 11):

> "This, we think, would be substituting the judgment and discretion of the commissioners for that of the directors and stockholders of the corporation. If such was the purpose and intent of the statute, a doubt might arise with reference to its constitutionality. For, ordinarily, the ownership of property carries with it the right of occupancy and management; and should a statute deprive the owner of the right to manage, it would, under ordinary circumstances, undermine his right to protect and make his property remunerative.

In the New Haven case (*supra*), the Court said (p. 431):

> "The commission were given extensive powers; but they should not be extended by implication beyond what may be necessary for their just and reasonable execution. They are not without limits when directed against the management or the operations of railroads."

V. One of the essential requisites of good business management is to promote the growth of the business and to provide facilities for taking care of that growth. This is peculiarly the case with a public utility. If properly managed, it is bound to grow, in an expanding community. The duty of the directors of such a company is not merely to supply existing patrons, according to some general average of their requirements, but to be in a position to comply instantly with their most extreme demands, that is, to have sufficient reserve plant at all times to

meet the "peak" demand. And that duty is not limited to existing patrons. As a community increases in population, the demand for service will necessarily increase accordingly; and it is just as much the duty of the utility to meet this constantly increasing demand as it is to meet the demands of existing patrons.

These observations are particularly applicable to a city like Washington, where the growth of the nation, as a whole, is reflected in the growth of its capital. The directors of this appellee may not be required to exercise the imagination and vision of a L'Enfant, in providing for the future; but they would be unfit for their positions if they did not make provision long in advance of immediate requirements for the demands of what in time promises to be the greatest capital city the world has yet seen.

This Court will take judicial notice of the fact that the present plant and offices of the Company, at 14th and C Streets, are situated in the direct line of the contemplated improvements extending from the Capital to the heights of Arlington. The Graceland Cemetery tract is admirably adapted for the business of the Company, when it shall be forced to surrender its present location. Is it not far better for the patrons of the Company to acquire this additional property when it can be obtained at a trifling expenditure, than to wait until notice to vacate has been served, when no suitable property may be available and when any property that may be obtainable will have advanced enormously in value with the growth and development of the City.

What has just been said of the Graceland Cemetery property applies also to the Great Falls Power

site. The Commission does not pretend that there are water power sites in the vicinity of Washington that can be picked up at bargain prices at any time when they may be needed. It bases its rejection largely on the fact that there is no reasonable probability that the Company will avail itself of water power in the near future. Recent events would seem to indicate that the day when water power may be substituted for steam may not be so distant as the Commission supposes. The advance in the development of hydro-electric energy has kept pace with the rapidly mounting cost of coal; and to the future resident of Washington, the acquisition by the Company of this Great Falls Power site may seem an act of supreme wisdom.

VI. In view of the power and duty of the directors to manage the affairs of the Company, their decision as to the advisability of making provision for the future cannot be disregarded by the Commission, unless the Court is of the opinion that such decision was entirely without justification, in other words, that they did not exercise the judgment which is expected of reasonably prudent men in their position and were guilty of such disregard of conditions, in acquiring these properties, as might make them liable to the stockholders for any loss resulting from their acquisition.

VII. The language of the statute (Par. 6) is, "used in *or useful to* the business of such utility". This clearly contemplates that other property than that in actual use may be included, if its ownership tends to promote the usefulness of the utility. There can be no doubt that property which may be required in the future is of this character.

VIII. In determining historical cost, the Commission entirely excluded the valuable I Street property, between 14th and 15th Streets, N. W., upon which is located sub-station 10 of the Company, in actual use at the time of the valuation. The location is one where high land values prevail. The property was originally part of a larger tract, which had been acquired at a cost of $87,179.88. In 1913, a portion of this tract, not required by the Company, was sold for a little more than the cost of the entire tract. By a calculation made by Mr. Sangster, the expert of the Commission (Report, Schedule 7, p. 538), he showed that, apportioning the cost, the land remaining unsold represented a cost of $28,374.80, leaving the cost of the portion that was sold $58,805.08. When the proceeds of this sale were received, the land investment should accordingly have been credited with the cost of the portion sold ($58,805.08), and the remainder of the proceeds of the portion sold ($28,488.67) should have been carried to profit and loss. Merely because the land account was credited with the total proceeds ($87,293.75), the item of cost of the portion now remaining ($28,488.67) was disallowed (Appendix 1, opposite p. 126, item 32). That mere details of bookkeeping should not govern in such cases is commented on in the next point (*post,* p. 48).

TENTH.

Additional errors.

I. *Intangibles and cost of development.*

As to these items, the Commission made no specific finding. It apparently could not escape the conclusion that some allowance must be made; but it thought the amounts should be very much less than those claimed by the Company. Its statement on the subject is as follows (1051):

> "The Commission finds that some allowance should be made for some such additional elements of value, but that the amounts should be very much less than is claimed by the Company."

Its own Director of Valuation conceded the propriety of taking the expenditures into consideration, although he was of the opinion that they should have been amortized out of earnings (464, 538, 541).

It is entirely a matter of conjecture how much, if anything, this allowance amounted to, or how the Commission attempted to account for what was allowed, or upon what items allowance was made. There is nothing to show what was allowed for "cost of development", or what the Commission regarded as intangibles upon which an allowance was proper, and how much, if anything, was allowed upon the intangibles or what the intangibles were.

There are many items included in the cost of development, or going value, upon which the courts have uniformly held that allowance must be made

in determining the value of the property as a whole.

Omaha *v.* Omaha Water Co., 218 U. S., 180, 202;
Cedar Rapids Gas Co. *v.* Cedar Rapids, 223 U. S., 655, 669;
Des Moines Gas Co. *v.* Des Moines, 238 U. S., 153, 165;
Newburyport Water Co. *v.* Newburyport, 168 Mass., 541;
Kings County Lighting Co. *v.* Willcox, 210 N. Y., 479, 492.

Findings of definite facts, and not hidden mental processes, are what a utility is entitled to be faced with upon the valuation of its property. The Commission had no more right to treat these elements of property in this vague way than it would have the right to do so with the tangible property or with the property as a whole, or in a condemnation proceeding. The facts must be found upon which the conclusion is based, so that the Company and the courts may see what was in the minds of the commissioners in reaching a conclusion as to the value of all of its property. In no other way can it possibly be ascertained, on review, what principles of law were observed or disregarded in reaching the final conclusion. In the Minnesota Rate case, this court distinctly recognized that appreciation could not be balanced with depreciation, but must be specifically found (230 U. S., 352).

II. *Working capital and supplies.*

The Company showed, without contradiction, that the amount actually employed at the time of

the inquiry and for some time prior thereto, was about $519,000 (796). The Commission arbitrarily reduced this amount nearly one-half, to $285,000 (980).

The question of how much working capital is required in a given business is peculiarly dependent upon the experience of each company conducting the business. It is an important element in the proper management of the business and should be left to the judgment of the directors, unless it is clearly apparent that they did not exercise any independent judgment in the matter. When, however, the judgment of the directors is confirmed by the experience of the company, as in the present case, the commission has no power to interfere with it (*ante*, p. 39).

III. *Rights, privileges, franchises and easements.*

A minor portion of this property had been acquired from the United States Electric Lighting Company, in 1902, by purchase and payment, by the issue of full paid stock of a par value of $1,977,150.63. At the time of the hearing, the appellee's engineers appraised all of these rights at $2,500,000 (650, 652, 859-860).

The Commission held that these rights had not been validly capitalized and refused to allow anything on account of them (965-6, 1034, 1036).

Where special franchises have actually been capitalized and the capital has passed into the hands of the public, the courts will permit a return upon the amount of capital stock so issued.

Willcox *v.* Consolidated Gas Co., 212 U. S., 19.

IV. *Property acquired out of the earnings.*

In ascertaining historical cost, the Commission excluded property costing $1,616,139.78, on the ground that the books of the Company showed that the property thus acquired had been paid for out of earnings (962).

As a matter of fact, this property had been paid for out of the earnings (723-4, 736-41, 783) obtained under statutory rates, to which the stockholders were legitimately entitled, both morally and legally (30 Stat., 1045, March, 1899; reenacted in 1900, 31 Stat. 563, still in force). The rates thus prescribed were, of course, reasonable.

Brooklyn Union Gas Co. *v.* New York, 189 N. Y., 334.

In the days preceding the regulation of public utilities and the introduction of prescribed systems of accounting, the public utility companies did what all other prosperous business concerns have done from time immemorial: instead of distributing all their earnings among the stockholders, they applied a large portion of them, and often the entire net earnings, to the acquisition of additional property and the development of the business. This was the practice of the appellee prior to 1910, when the Interstate Commerce Commission prescribed a system of accounting which required all such expenditures to be charged to capital account. Had that system been followed by the appellee prior to 1910, all of these expenditures, which were disregarded by the Commission in determining the historical cost, would have shown in the capital account; but property legitimately acquired by the stockholders, at their own expense, cannot be excluded merely because its cost was

originally charged against net earnings, rather than against principal. In such cases, the courts pay no attention to the mere details of bookkeeping.

Baldwin Locomotive Works *v.* McCoach, 221 Fed., 59, 60;

Mitchell Bros. Co. *v.* Doyle, 225 Fed., 437, 440; Aff'd. 235 Fed., 686; 247 U. S., 179;

Southern Pacific Company *v.* Lowe, 247 U. S., 330, 337-8;

Gulf Oil Corp. *v.* Llewellyn, 248 U. S., 71, 72.

In Mitchell Bros. Co. *v.* Doyle (*supra*), the Circuit Court of Appeals said (235 Fed., 686, 692):

> "There is nothing magical in bookkeeping; it does not create facts; it only records them. . . . Book entries may be of value as an admission when a tax is to be assessed and when there is a dispute as to the fact, but they cannot work an estoppel as to an undisputed fact."

This Court has repeatedly recognized the principle that additions and betterments paid out of earnings and charged to operating expenses or to surplus must be valued as capital investment.

Reagan *v.* Farmers' Loan and Trust Co., 154 U. S., 362, 407-8;

Ill. Cent. R. R. Co. *v.* I. C. C., 206 U. S., 441;

Minnesota Rate Cases, 230 U S., 352;

Missouri Rate Cases, 230 U. S., 474;

Arkansas Rate Cases, 230 U. S., 553.

V. *Property sold, scrapped or abandoned.*

In determining historical cost, the Commission deducted $144,285.75, because its accounting ex-

pert, Mr. Sangster, had been unable to identify, on the ground, various items of property purchased from time to time in the past, and, consequently, assumed that it no longer existed (959). That witness conceded that the property, which he had been unable to follow, though he did not attempt to make an inventory, had cost $388,953.85 (124, 959). When questioned as to his reason for concluding that the property no longer existed, he stated that he was unable to "resuscitate his mental processes" in the matter (210).

Property which the books of the Company showed to have been purchased and placed in service could not be excluded, unless affirmative evidence was produced that it had been discarded, which the Company would be at liberty to controvert if the witness was examined. The Commission was not of that way of thinking. It ruled, in effect, that if, upon a test, the witness could "resuscitate his mental processes" as to a few items, that was conclusive evidence to the Commission that the entire property represented by the $388,953.85 had ceased to exist; and it threw the burden upon the Company of disproving the vague generality, if it could. The attitude of the Commission on the subject was indicated by its reference to the alleged lost items (181):

> "All we need to give you, as a matter of right, is our totals, and say, here they are, shoot at them."

As well as he could, under such vague and impossible conditions, Mr. Ham took the witness in hand and so far resuscitated what the witness was pleased to term his "mental processes" as to make it clear that he had been in error respecting items aggregating $244,668.10. As to what remained

($144,285.75), his mind was a blank; and, *accordingly*, the Commission threw out this amount in the valuation of the property (Appendix 1, opposite page 126, item 7)!

VI. *Prejudicial evidence erroneously considered.*

The opinion of the Commission discloses the fact that in valuing the property of the appellee, it was substantially influenced by evidence received of compromise agreements made in valuing the properties of other utilities in the District, in proceedings to which the appellee was not a party (1013-14, 1023-4).

The consideration thus given to basic facts, in the case of other utilities operating under different conditions, was first revealed to counsel for the appellee when served with a copy of the opinion. The necessary effect of this action on the part of the Commission was to deprive the Company of its property, without due process of law.

This error was called to the attention of the Supreme Court of the District; but it was disregarded (49), in spite of the fact that this Court has held such error to be substantial and prejudicial.

Int. Com. Comm. *v.* Baird, 194 U. S., 25;
Int. Com. Comm. *v.* Union Pacific Ry. Co., 222 U. S., 541;
Oregon Railroad *v.* Fairchild, 224 U. S., 510;
United States *v.* B. & O. R. R. Co., 226 U. S., 14, 20;
Int. Com. Comm. *v.* L. & N. R. R., 227 U. S., 88.

The Commission went still further than this, in accepting the unverified reports of its experts as *prima facie* evidence upon which its decision was largely based.

The right of cross-examination did not correct this error. A witness should not be permitted, in *quasi* judicial proceedings, to prepare beforehand a carefully devised argument in support of certain preconceived theories, adapting the facts to those theories and submitting the whole as evidence, without even taking the trouble to present his conclusions under oath.

Not only were these so-called reports received as *prima facie* evidence of their contents (72-3), but the Commission went so far as to limit the Company in the right to examine the authors of the reports concerning the details contained in them (178, 180, 181, 182). This was a disregard of the fundamental rights of the Company.

Wichita R. R. & L. Co. *v.* Commission, 43 Sup. Ct., 51.

ELEVENTH.

Appellants' Brief.

I. *Criticism of the Company's officers.*

The appellants repeat the charge made against the officers of the Company in the lower Court and before the Commission, of not having facilitated the activities of its experts in a manner to satisfy their exacting demands (Brief, p. 14).

1. The record does not disclose any valid evidence on the subject. In the report of Mr. Pillsbury, he criticizes the officers of the Company for not cooperating with him. But that is not evidence: it is the petulant statement of an interested witness, not even made under oath and without the production of a single fact in its support. The appellants endeavor to fortify the charge by quoting a statement made by Mr. Justice Gould (brief, p. 16); but that statement was made on the same lack of evidence to support it.

2. This unworthy reflection upon the officers of the Company was not justified, even if it had been based on some evidence, in view of the fact that the Commission did not attempt to exercise the powers conferred upon it by Paragraphs 36 and 37 of the Act. If there had been any actual disposition shown by the officers of the Company to obstruct the investigation by the Commission, or even to refuse to cooperate with the experts in a manner to satisfy them, the Commission could, under Paragraph 36, have appointed an agent to examine the officers and employees under

oath, and, under Paragraph 37, it could have compelled the officers to deliver "a complete inventory of all its property in such form as the Commission may direct".

3. It is rather more than a mere presumption that any difficulty encountered by the Commission's experts was due to the unfortunate manner in which they entered upon their task. The person chosen as the Director of the Valuation Bureau was Doctor Bemis, a well known professional commission expert, who, in the Des Moines case, was held not to be a competent witness (514), and who, in the present case, insisted upon his own theory of investment cost (506), without regard to the requirement of the statute as to reproduction cost also (515).

II. *Mistaken attitude of the Supreme Court of the District.*

In their brief (pp. 130-1), the appellants seek to justify the decision of Mr. Justice Gould in the trial Court by asserting that he merely followed the decisions of this Court in numerous cases, where it held that the findings of the Commission will not be disturbed if there is substantial evidence to sustain them.

That is exactly what we complain of. This Court has applied the principle to cases arising under entirely different statutes and different conditions, where no duty was imposed upon the trial court to review the proceedings *ab initio* and to receive additional evidence, if offered, and where merely the burden of proof was thrown upon the party complaining of the order of the Commission. That is a burden imposed upon all complainants.

III. Nothing is quite so clear in the record as that the valuation of the property was made as of July 1, 1914 (*ante*, p. 13).

This is expressly conceded in the appellants' brief (pp. 2, 4, 6, 8, 9). That the appellants are not comfortable in making this concession and desire to avert its consequences is obvious from the following statement contained in their brief (p. 5):

> "This date was *not* to be the date of the final valuation. The final valuation was made as of December 31, 1916."

The opinions of the Commission and the trial Court show that this statement is not correct; and it is contradicted by the Commission's Director of Valuations (526):

> "At the date of the valuation, which has been fixed at some period of time, and for convenience it was fixed at June 30, 1914, being about two months after the valuation was undertaken, and there has been no effort made to bring this valuation down to the present time, though it has always been his belief that it might ultimately be done, but there has been no attempt made yet to do it, perhaps for lack of appropriation."

IV. *Radical differences in determining the rate base.*

The addition by the Commission of 5% to the alleged reproduction cost of the physical property, as found by the Commission's engineers, was an adjustment voluntarily made by Mr. Pillsbury to cover certain errors or omissions in inventory which he discovered on review of his work and did not represent any increased labor or material costs (981).

V. *Great Falls Water Power Company.*

Counsel for appellants charge Mr. Ham with "serious error" (p. 48), in stating that the Great Falls Power site was originally planned for the account and benefit of the Potomac Electric Power Company; and, to verify their assertion, they concededly (p. 50) refer to evidence which is not in the record.

1. Nothing that they have thus produced is in conflict with Mr. Ham's statement. On the contrary, the statement of Mr. McDermott, which is relied upon (Brief, pp. 48-9), makes it entirely clear that the acquisition of the property could, as a practical matter, have been made only for the benefit of the Potomac Company, which alone could have utilized the property to its full capacity.

2. The evidence relied upon further shows (p. 45) that $425,000 was paid for the interest in this property as far back as 1902; that, in 1908, the Potomac Company was authorized to acquire that interest for $610,000, and that this contract was finally modified in 1913, by authorizing the issue of capital stock of the par value of $1,000,000, instead of the cash payment: certainly not an unreasonable business proposition, considering the lapse of five years and the acquisition of the property without issuing any direct obligation.

3. On this subject, appellants quote from the opinion of Mr. Justice Gould in his animadversion upon the Company (Brief, p. 52) for having acquired this stock "shortly before the Public Utilities Law was enacted." The resolution of the Company adopted in May, 1908, and set forth in appellants' brief (p. 50), ex-

pressly shows that the purchase was authorized at that time, and that the completion of it, in 1913, was merely giving effect to the purchase upon a somewhat different basis of payment.

VI. *Property acquired from United States Electric Lighting Company.*

The following statement is made in the appellants' brief (p. 33):

> "According to the testimony of Ham, the amount paid for the property rights, property and franchises of the U. S. Electric Lighting Co. was not excessive. He there states that in addition to the physical property acquired, the purchase price also included the expense of organization, financing, promotion and development. This is no doubt true to a certain extent, but it is not believed that the Company has been unjustly treated in setting aside this increased book value."

The appellants seek to justify the elimination in question because of allowances of a similar character for other separate and distinct properties previously purchased. Although there was no evidence that the price paid for the property, property rights and franchises of the United States Electric Lighting Company was excessive, and although the evidence showed that the book value did not cover certain elements of value which were properly included in the consideration for the purchase, the very large sum of $1,977,150.63 was excluded, upon the bare assumption of its accounting witness, that it was a premium which the appellee paid for the property over and above its book value, and because the two companies were controlled by the same interests. This ruling and the reasoning upon which it was based was adopted and approved by the trial Court (764-6).

In the property acquired was included the properties of earlier constituent companies (Heisler Electric Company and Brush Swan Electric Company). In the case of those companies, the Commission allowed these organization and development expenses. But, in entire disregard of the principle thus recognized, it refused to allow such expenditures in the case of the U. S. Electric Lighting Co., although it was shown (765) that by reason of the acquisition of that Company, substantial economies in operation were effected. The entire transaction was similar to that approved by this Court in Willcox *v.* Consolidated Gas Co. (214 U. S., 19).

VII. In their brief (p. 25), the appellants refer to certain items added by the bill of complaint subsequent to the date of the valuation. Mr. Ham specifically testified that to the historical cost there should be added certain allowances for taxes and insurance during construction, increases in costs on account of renewals, additions and improvements, and cost of obtaining business (795). All of these items were disregarded by the Commission.

VIII. Many of the decisions of State Commissions, referred to in the appellants' brief (pp. 73-79), are not in point, and do not sustain the contentions made; and the decisions referred to as having been made in Illinois, Maryland, New York and Virginia have been overruled by the courts.

Commission *v.* Springfield Gas, etc., Co., 291 Ill., 209;

Havre de Grace, etc., Bridge Co. v. Towers, 132 Md., 116.

People *ex rel.*, N. Y. State Railways *v.* P. S. C., 202 App. Div., 576;

Petersburg Brass Co. *v.* Petersburg, 110 S. E., 533.

TWELFTH.

The judgment of the Court of Appeals should be affirmed, with costs.

Washington, January, 1923.

S. R. BOWEN,
Attorney for Appellee.

JOHN A. GARVER,
JOHN S. BARBOUR,
Of Counsel.